Sovereign Wealth Funds: Important Investors With Specific Tax Concerns

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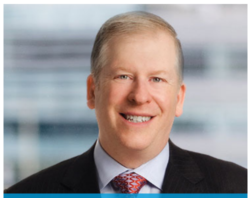
Sovereign Wealth Funds (SWFs) are an important source of capital for private equity funds. SWFs generally enjoy favorable tax treatment in the U.S., but this treatment is subject to specific limitations; SWFs typically require separate LPA provisions or side-letter protection to ensure that their favorable tax treatment is not thwarted by the activities of the funds in which they invest.

US Tax Exemption. Foreign governments (including for this purpose wholly-owned subsidiaries (1) formed in the same jurisdiction as the foreign government, (2) the net earnings of which inure entirely to the benefit of such subsidiary or the foreign government, and (3) all of the assets of which must be paid to the government in the event of liquidation) are exempt from U.S. tax on certain U.S. source income, including dividends and interest paid by U.S. payors, and gain on the sale of stock and bonds issued by U.S. issuers.

Commercial Activity Income. Importantly, income from commercial activities (CAI) is not exempt from tax. Moreover, income received by a controlled commercial entity (CCE) does not benefit from this exemption, nor is income (e.g., dividends) from a CCE or gain from the sale of a CCE exempt.

Commercial activities include activities ordinarily conducted with a view toward producing income, but do not include investing in stocks and bonds or trading in stocks, securities, or certain commodities for the foreign government's account. A CCE is an entity in which a foreign government owns 50% or more of the interests (or in which the foreign government has effective control) and that is engaged in commercial activities. As SWFs often are controlled entities, if such entities engage in commercial activities (anywhere in the world) that may preclude a SWF from benefiting from tax exemption on U.S. source income (even passive income, such as dividends and interest). Thus, SWFs regularly request that PE funds not generate CAI, and expect funds to use below the fund blockers or alternative investment vehicles that block such income for SWF investors.

Generally, the nature of the income derived by, and activities conducted by, partnerships flows through and retains its character in the hands of their partners. To ameliorate the extreme result that CAI recognition by a partnership in which a SWF is invested would taint all of the U.S. source income of the SWF, proposed regulations provide that CAI derived through a limited partnership will be taxable, but generally will not taint other U.S. source income so long as the SWF does not have rights to participate in the management and conduct of the partnership's business. Though these proposed regulations indicate that taxpayers may rely on them even before they are finalized, SWF investors generally do not rely on the proposed regulations because of the risk that they will not be enacted and because of the lack of clarity as to certain terms (*e.g.*, whether serving on a fund's limited partner advisory committee constitutes control).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